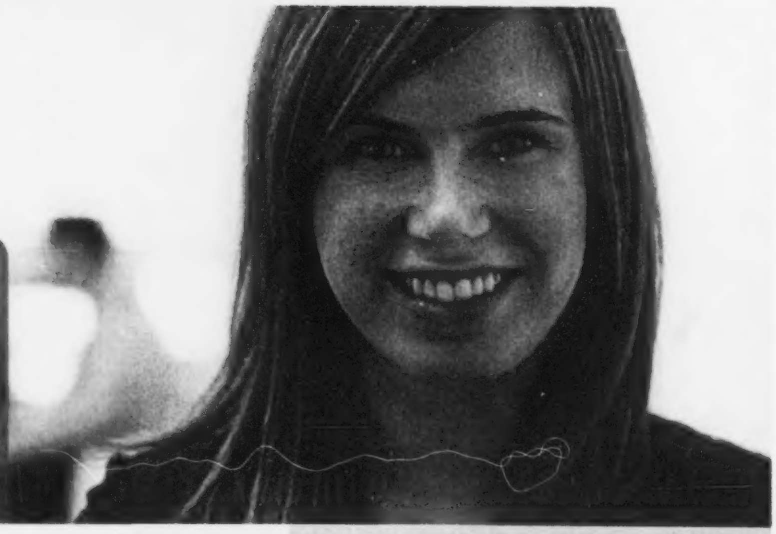
BDC
Entrepreneurs first

economic LETTER

MARCH 2011



OVERVIEW OF THE FINANCIAL POSITION OF CANADIAN COMPANIES

The recent recession, like all recessions, was hard on companies, which saw their profits fall substantially. Because of the financial crisis that preceded the recession, in addition to the decline in demand for their goods and services, many companies faced unprecedented tightening of their credit conditions. We might have expected not only that the proportion of business bankruptcies would rise, as usually happens during a recession, but also that the jump would be bigger than in previous recessions. However, that did not happen. On the contrary, the rate of business bankruptcies, which had been declining since 1997, continued to fall during the recession. That being said, the bankruptcy rate is not a perfect indicator of businesses' financial position because firms in difficulty often close their doors before they are forced into bankruptcy.

Generally, companies were in a strong financial position at the start of the economic crisis: their debt was at its lowest level in forty years and their liquidity level was very high. Their debt level, measured by the debt-to-equity ratio, had been falling steadily since peaking in 1992. This ratio declines when a company uses its own equity–retained earnings and net share issues–rather than relying on borrowed funds to finance growth.

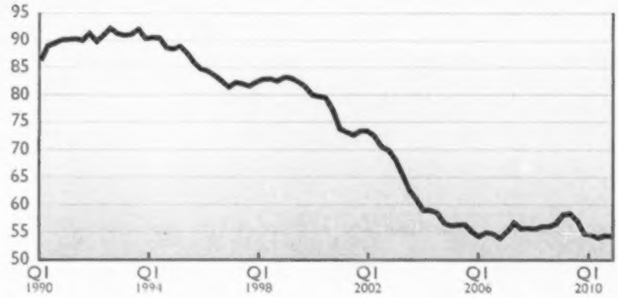
According to a recent study by Statistics Canada, the business debt ratio fell even further in 2003 when corporate profits increased substantially. Net share issues also helped drive down the ratio starting in 2005. In 2008 and 2009, despite the fall in net profits and the stock market slide triggered by the recession, which hobbled equity growth, there was only a slight increase in the business debt ratio because access to and demand for business credit declined. Less borrowing has a distinct benefit: companies are less vulnerable to a rise in interest rates than when their balance sheets are carrying more debt.

In addition to reducing their debt level since the early 1990s, companies also improved their liquidity position. At the start of the recession their liquidity ratios were unusually high, which helped them cover their regular expenditures when access to credit tightened. ▼

BDC's Monthly Economic Letter is produced by the Strategy and Enterprise Risk Management department and is based on a variety of public sources of economic data. Reliance on and use of this information is the reader's responsibility.

This quick overview of the financial position of Canadian companies is reassuring. It gives us reason to believe that, generally, the private sector is relatively well placed to cope with a potential increase in interest rates and take over from the public sector in supporting future economic growth. ■

Non-Financial Corporations Debt
(credit market debt to equity)



Source: Statistics Canada

CANADA

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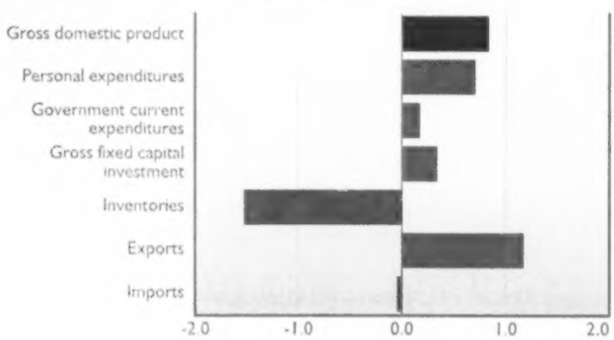
Recent economic data confirm the strength of economic activity in Canada. Real GDP posted stronger growth than expected in the last quarter of 2010, employment started off 2011 strong and companies have returned to profitability. That being said, caution is still needed: the U.S. economy is still not very strong, as evidenced by the weakness of its labour market, and the jump in Canadian exports in the fourth quarter – mainly due to foreign demand for energy products and especially crude oil – might only be temporary.

Economic growth accelerated at the end of 2010

Real GDP increased 3.3% in the fourth quarter of 2010, bringing economic growth for 2010 to 3.1% after a 2.5% decline in 2009. Strength in the fourth quarter was mainly due to a rebound in exports (17.1%), particularly of energy products, while imports rose slightly (0.5%). Consumer spending also posted strong growth (4.9%), as did investment in non-residential construction (21.0%). On the other hand, residential construction was down (-5.7%), investment in machinery and equipment barely changed, and inventory values dropped significantly. Corporate profits increased substantially (41.1%), which is reason to believe that the private sector could take over from the public sector in sustaining the economy in the coming quarters. However, caution is required: the jump in exports in the fourth quarter – mainly due to greater demand for crude oil – might only be temporary.

Contributions to percent change in real gross domestic product, fourth quarter 2010

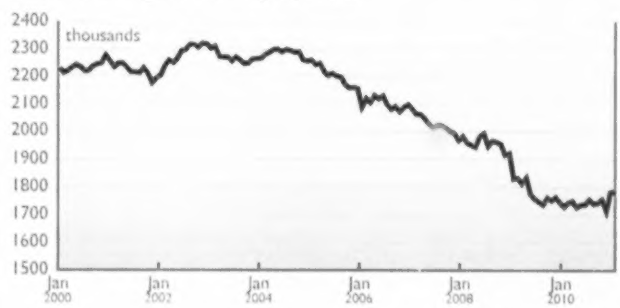


Source: Statistics Canada

Employment starts off the year strong

69,200 jobs were created in January, and this increase was spread almost equally between full- and part-time jobs. Unemployment edged up from 7.6% to 7.8% as more people looked for work. Renewed labour market activity often brings discouraged unemployed workers back into the work force. The service sector accounted for the majority of the jobs created in January. The manufacturing sector added only 4,000 jobs but had already gained 66,000 the previous month. Since the loss of 550,000 jobs between July 2004 and July 2009, employment in this sector has stabilized, as the graph below shows. The solid performance of the labour market in recent months bodes well for economic growth. ▼

Manufacturing Sector Employment



Source: Statistics Canada

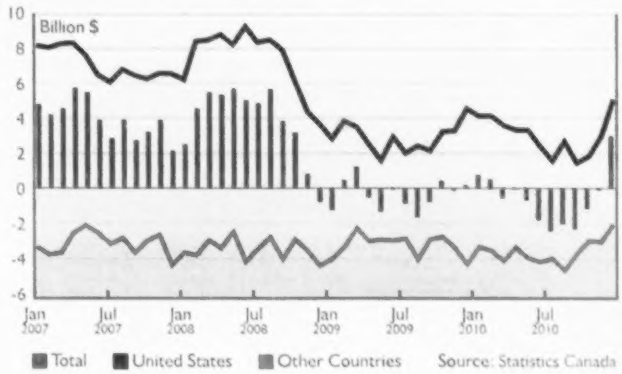
Housing market should remain stable in 2011 and 2012

Housing starts were up from 169,000 units in December to 170,400 in January, entirely due to an increase in rural areas since urban starts were down. The average number of starts in 2010 was 189,930 units, compared to 149,081 in 2009. The CMHC predicts that the number of starts will be 177,600 in 2011 and 183,800 in 2012. Low mortgage rates, rising employment and incomes, and an increase in net migration will combine to sustain housing starts while the new mortgage insurance rules and slowing population growth will have a moderating effect. The CMHC also expects sales of existing homes, which were 2.9% lower in 2010 than the previous year, to decline by 1.1% in 2011 but increase by 4.8% in 2012.

Balance of trade posts its first surplus since February 2010

The balance of trade went from a $115 million deficit in November to a $3 billion surplus in December, which is the first trade surplus since February 2010 and the biggest since November 2008. The trade surplus with the United States grew from $3.0 billion in November to $5.1 billion in December while the deficit with other countries declined from $3.1 billion to $2.1 billion (see graph below). Exports jumped 9.7% in December, due more to higher volume than higher prices for exported products. Imports edged up 0.7%, with increases across nearly all sectors. ■

International Trade Balance



★ UNITED STATES

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Although the U.S. economy has been growing since the second half of 2009, it is still fragile in some respects: job growth is weak and supply in the housing market far exceeds demand. However, there are some encouraging signs, such as the Purchasing Managers Index for the manufacturing sector (Institute for Supply Management–ISM), which indicates that growth, already sustained in this sector for more than a year, should continue, and the rise in the Consumer Confidence Index, which seems to point to an acceleration in consumer spending in the coming quarters.

Real GDP growth revised down

Real GDP growth in the fourth quarter of 2010 has been revised down from 3.2% to 2.8%. For 2010 as a whole, real GDP grew 2.8% after declining 2.6% in 2009.

Job creation weak in January

Non-farm employment increased by only 36,000 jobs in January after posting an average monthly gain of 128,000 over the previous three months. January's disappointing numbers were partly due to a fall-off in the construction sector, where employment was disrupted by bad weather. Even so, the private sector added jobs for the eleventh month in a row (see graph). The effect of bad weather on the construction sector should be temporary, and February should see employment in that sector rebound.

Monthly Change in Non-Farm Employment

Supply still far exceeds demand in the housing market

Housing starts were up 14.6% in January over the previous month but the increase was limited to the very volatile multiple units segment. Single family home starts, where growth is usually more stable, were down in January from December. Sales of existing homes continued their uptrend, with an increase of 2.7% in January over the previous month. However, the inventory of homes for sale remained high at the end of January, and at the current rate of sales it would take 7.6 months to clear this inventory. ▼

Business and consumer confidence continues to improve

The Institute for Supply Management Purchasing Managers Index for the manufacturing sector rose in February for the seventh consecutive month, reflecting a distinct improvement in employment among other things. Also, the Conference Board Consumer Confidence Index rebounded in February to reach its highest level in three years. The firming up of business and consumer confidence should solidify the economic recovery in the coming quarters. ■

INTEREST RATES

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Bank of Canada could raise its key interest rate sooner than expected

On March 1 the Bank of Canada again decided to leave its key interest rate unchanged at 1%, the level it has been at since September 2010. However, economic growth was stronger than the central bank had predicted in its last Monetary Policy Report (1.8% and 3.3% in the third and fourth quarters of 2010 versus forecasts of 1.0% and 2.3%). The strength of the Canadian economy could induce the Bank to raise its key interest rate sooner than expected, i.e. in the second quarter rather than the third. The Federal Reserve, on the other hand, is not expected to tighten its monetary policy for many months because of continuing uncertainty about the strength of the U.S. economy. As a result, we could see a widening of the gap between Canadian and U.S. key interest rates before the end of the second quarter of 2011. ■

OIL AND THE LOONIE

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Price of oil and Canadian dollar rising

The price of a barrel of oil rose to a level not seen since October 2008. The increase is being driven by fears that oil supplies will be disrupted by the current instability in Libya and several other Middle Eastern countries and could spread to other oil exporting countries. The Canadian dollar rose in tandem with the price of oil to reach its highest level in three years by the end of February. ■

Crude Oil Price and Canada - U.S. Exchange Rate

Source: Global Insight

SME CONFIDENCE

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Small business leaders remain optimistic

> The renewed optimism expressed by small business leaders at the end of 2010 is continuing, as shown by the CFIB Business Barometer Index, which rose slightly in February to 69.4, its highest level in 11 months.

> Business leaders in the health and education services sector and natural resources sector were the most upbeat.

> Entrepreneurs are least optimistic in the hospitality sector, which is suffering from the strong loonie, followed by the transportation sector, which is feeling the effects of rising fuel prices.

> The average price increase planned for the business' own products now stands at 1.8%, the highest growth in more than two years. ■

BUSINESS CREDIT CONDITIONS

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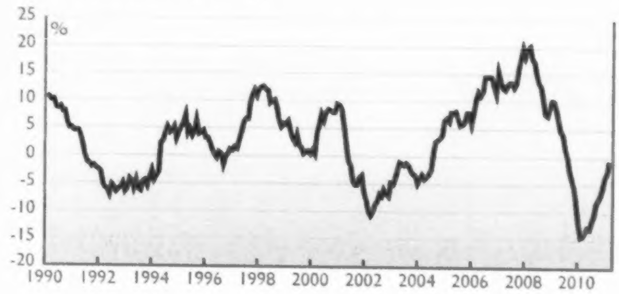
Business credit continues to expand

Business credit from chartered banks continued to rise in January and its annual growth is now close to returning to positive territory after being negative for the past two years. In January, short-term credit, which accounts for 87% of business credit from chartered banks, was 1.2% lower than a year ago while long-term credit was 5.2% higher than last year. ■

Business Credit from Chartered Banks
(year-over-year percentage change)



Source: Bank of Canada

KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2010				Latest		Forecast	
	2007	2008	2009	2010	Q1	Q2	Q3	Q4			2011	2012
Real GDP (% growth)	2.2	0.5	-2.5	3.1	5.5	2.2	1.8	3.3	Dec	0.5	2.6	2.7
Machinery and Equipment Expenditures (% growth)	4.2	-0.9	-20.3	11.2	14.8	29.7	24.6	0.7			13.3	8.3
Pre-Tax Corporate Profits (% growth)	1.9	8.0	-32.3	18.4	38.2	-6.9	0.4	41.1			10.7	9.4
Industrial Production (% growth)	-0.5	-4.5	-9.4	4.7	10.5	8.8	2.8	2.0	Dec	1.1	3.4	3.7
Industrial Product Prices (% growth)	1.5	4.3	-3.5	1.0	3.6	1.2	-1.0	6.5	Jan	0.2	2.8	3.3
Non-Residential Construction (% growth)	2.3	7.7	-19.5	-0.5	10.6	2.4	12.7	21.0				
Housing Starts (' 000 units)	228	213	148	192	198	198	192	179	Jan	170	173	178
Personal Expenditures (% growth)	4.6	2.9	0.4	3.4	4.1	1.9	2.7	4.9			2.8	2.5
Consumer Price (% growth)	2.1	2.4	0.3	1.8	2.2	-0.1	2.4	4.4	Jan	0.3	2.3	2.1
Employment (% growth)	2.4	1.7	-1.6	1.4	1.5	3.4	1.4	0.4	Jan	0.4		
Unemployment Rate (%)	6.0	6.1	8.3	8.0	8.2	8.0	8.0	7.7	Jan	7.8	7.6	7.3
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	68.4	66.7	64.7	66.7	Feb	69.4		
Manufacturers Confidence Index (CFIB)	64.5	52.7	56.0	68.6	69.7	69.0	65.7	70.2	Feb	72.3		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business. Annual growth, quarterly growth at annual rate and month-over-month growth.